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Global growth forecasts

The International Monetary Fund downgraded its economic growth forecasts for most countries in its latest report.

US gross domestic product

The US GDP print for Q2 was not good. But in my view, it was not as bad as the headline figure would suggest.

Russian energy supply

Russia reduced natural gas exports to Europe. This suggests a far greater likelihood that the eurozone may go into recession.

We've gotten a number of client questions over the past week on a variety of issues from downgraded global growth projections, to the status of the US economy (is it in a recession or not?), to what we're learning during corporate earnings season. Below, I answer a few of the most common concerns.

Q. Why did the International Monetary Fund (IMF) downwardly revise its growth forecasts for 2022? How does it matter?

A. The IMF updates its forecasts several times a year. Not surprisingly, given that the world is in an economic slowdown, the IMF has downgraded its growth forecasts for most countries in its latest report.¹ Of the major economies, the US was revised downward the most, from 3.7% to 2.3%. The eurozone was revised down modestly, which is somewhat surprising given the significant inflationary pressures hurting the economy, and Canada also received a modest revision, from 3.9% to 3.4%. China was revised down substantially, from 4.4% to 3.3%. This seems a bit excessive, in my view, given the significant stimulus that China is injecting into its economy — although policymakers have dispensed with their growth target for 2022, and economic headwinds are being caused by the property sector.

As with any growth/inflation/rates forecasts, it's difficult to be precise so the direction usually matters more than the actual numbers. The key takeaway from the IMF, as articulated by its chief economist Pierre-Olivier Gourinchas, is that the world is running the risk of going into recession: "The outlook has darkened significantly since April. The world may soon be teetering on the edge of a recession, only two years after the last one." I do believe we will be able to avoid a global recession, but so much is dependent on the Russia-Ukraine war, how Europe manages its energy crunch, and how robustly the Chinese economy rebounds. And all these challenges are clearly not good for the world economy and markets.

But in many ways, these issues are not new news; what matters going forward is likely to hinge on how central banks move going forward. To the extent that growth comes under pressure, it is likely that the domestic and demand-driven elements of inflation will recede — even if the energy component remains a problem. Other commodity prices — though still elevated — are down quite a bit from their wartime highs year-to-date (other than natural gas prices in Europe — the main front in the weaponization of energy). All of which suggests that central banks may continue to tighten but less aggressively than was starting to be feared just recently. And that should help limit damage to asset prices — a process that may already have begun in recent weeks.

Q. How bad was the US gross domestic product (GDP) report for the second quarter?

A. The first estimate of US second-quarter GDP is -0.9%, coming on the heels of -1.6% in the first quarter.² What's more, the second-quarter estimate was far below consensus expectations. Two consecutive quarters of declines means the US is technically in a recession. However, as has been noted before, there are other economic conditions that indicate a more solid economic environment. As Federal Reserve Chair Jay Powell posited last week in his press conference, a better definition of recession is a broad-based decline in economic activity across many industries.

This decline in second-quarter GDP was largely due to weaker inventory accumulation, which arguably may be a one-time negative impact to GDP. (Real final sales rose 1.1% in Q2, after falling 1.2% in Q1).² Notably, the decline in first-quarter GDP was largely due to a trade imbalance (exports were far lower than imports due to weaker economic growth outside the US), an area where data has been erratic. In Q2, net exports improved a lot after the Q1 aberration, but we would expect that to revert to a mild negative again.

This was not a good GDP print, but in my view, it was not as bad as the headline GDP would suggest. This could be a "bad news is good news" scenario, serving as a catalyst for the Fed to pivot to a less aggressive tightening path perhaps as early as September — if other data cooperates in coming weeks.

That said, investors may also need to contend with the real possibility that we are not actually in a full recession, given the strength of household and other private-sector balance sheets in the US, as well as the tightness of the labor market. The negative GDP prints could reflect shifts in consumer spending brought on by the pandemic as well as wartime commodity shocks (a shift in spending from services to goods in lockdown, a pivot back to services as economies reopened, and then a focus on "basic needs" as food and energy prices soared) — as well as business spending.

Q. What did we learn from the Fed meeting last week?

A. As I expected, the Fed raised rates 75 basis points; this seemed appropriate given that preliminary University of Michigan consumer inflation expectations for five years ahead fell to 2.8% (the most recent data point released before they met) and the US economy appears to be softening quickly.³ In addition, Fed Chair Jay Powell announced that the Fed would be dispensing with forward guidance; this development underscores just how data-dependent the Fed has become. That suggests a very distinct possibility that the Fed could pivot to a less aggressive path for tightening later this year — perhaps as early as September

Powell also made it clear that balance sheet reduction will shift into high gear in September. Markets have thus far reacted positively to the news that the Fed will be very sensitive to data going forward, and that Powell doesn't believe tightening thus far has been fully reflected in the economic data. I expect to hear from Fed officials in coming days who may sound very hawkish, trying to tamp down market ebullience and maintain their credibility as they fight inflation.

The key takeaway is that, contrary to some views, the Fed did NOT pivot last week – but it did open the door to pivoting in coming months.

Q. How has US earnings season been so far?

A. Overall, 56% of S&P 500 Index companies have reported earnings for the second quarter, with 73% of S&P 500 companies reporting a positive earnings per share surprise and 66% reporting a positive revenue surprise.⁴ However, there have been some significant negative surprises along the way. And many consumer discretionary companies have yet to report; they have been under pressure given the impact of inflation on spending power for consumers, so I suspect their earnings results might be more negative.

There were valuable insights to be gleaned from the earnings calls. As I mentioned in a previous blog, some financial services firms underscored the continued strength of the US consumer. In addition, a number of companies mentioned that the labor market has eased. This summary underscores the improving conditions: “across the 88 Dow Jones and mid- or large-cap consumer companies that discussed the labor market, 35 companies signaled improved labor availability, compared to only one that saw labor shortages worsening. In fact, all three of the human resources and staffing firms that commented cited improved labor availability.”⁵ In addition, some companies even mentioned an easing of wage growth pressures.

In terms of third-quarter earnings, we have already seen some downward revisions in the month of July. In fact, analysts lowered earnings per share (EPS) estimates for the third quarter more than usual last month. The Q3 bottom-up EPS estimate (which aggregates the median EPS estimates for Q3 for all the companies in the S&P 500 Index) decreased by 2.5% (to \$57.98 from \$59.44) from June 30 to July 28.⁶ I expect more downward revisions to come.

Q. What’s happening with China’s property market?

A. The property market in China is increasingly problematic, and it is weighing on the country’s overall economy. Home prices are falling, many housing projects have stalled, and an increasing number of property owners are refusing to pay the mortgages on their properties currently under construction. However, China’s Politburo did meet last week and pledged to support the property sector, including ensuring that unfinished building projects are completed.

In terms of the larger economy, the official July manufacturing Purchasing Managers’ Index (PMI) fell disappointingly to 49.0 from 50.2 in the prior month, though the good news is that non-manufacturing remains elevated at 53.8.⁷ The weak manufacturing PMI indicates that the recent reopening-related economic recovery has started to falter, likely due to amplified property market woes and new pockets of COVID infections. Policymakers are likely to roll out further infrastructure stimulus to combat growth headwinds (as well as specifically supporting the property sector).

Q. What will happen to the eurozone now that Russia is reducing its natural gas supply to Europe?

A. Last week, Russia again reduced its natural gas supply to Europe in order to add to pressure to EU nations. The total Russian supply being exported to Europe via the Nord Stream 1 pipeline is now approximately 20% of capacity.⁸ This has driven up energy prices very quickly and suggests a far greater likelihood that the eurozone may go into recession, despite seeing improved GDP growth in the second quarter. We will watch to see how Europe as a whole builds gas reserves and finds substitute supplies from other regions to help reduce the risk of rationing should Russia continue to restrict or even stop EU gas exports.

With contributions from Arnab Das, Paul Jackson, Adam Burton, David Chao

Notes

¹All IMF data and quotes come from the International Monetary Fund's World Economic Outlook as of 7/25/22.

²Source: US Bureau of Economic Analysis, 7/28/22

³Source: University of Michigan as of 7/15/22

⁴Source: FactSet Earnings Insight, as of 7/29/22

⁵Source: Goldman Sachs Economic Research, 8/1/22

⁶Source: FactSet Earnings Insight, as of 7/29/22

⁷Source: China's National Bureau of Statistics, 8/1/22

⁸Source: CNBC, "3 charts show Europe's unprecedented natural gas crisis," 8/1/22

Important information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

All investing involves risk, including the risk of loss.

The International Monetary Fund (IMF) is a group of 190 member countries that supports economic policies that promote financial stability and monetary cooperation.

Earnings per share (EPS) refers to a company's total earnings divided by the number of outstanding shares.

Gross domestic product is a broad indicator of a region's economic activity, measuring the monetary value of all the finished goods and services produced in that region over a specified period of time.

A basis point is one hundredth of a percentage point.

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

Purchasing Managers' Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

The opinions referenced above are those of the author as of Aug. 1, 2022. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.